

VZCZCXRO8767
RR RUEHRG
DE RUEHSO #0241/01 1141910
ZNR UUUUU ZZH
R 241910Z APR 09
FM AMCONSUL SAO PAULO
TO RUEHC/SECSTATE WASHDC 9125
INFO RUEHBR/AMEMBASSY BRASILIA 0277
RUEHRG/AMCONSUL RECIFE 4352
RUEHRI/AMCONSUL RIO DE JANEIRO 9125
RUEHBU/AMEMBASSY BUENOS AIRES 3477
RUEHAC/AMEMBASSY ASUNCION 3724
RUEHMN/AMEMBASSY MONTEVIDEO 2898
RUEHSG/AMEMBASSY SANTIAGO 2724
RUEHLP/AMEMBASSY LA PAZ 4099
RUCPDO/USDOC WASHDC 3266
RUEATRS/DEPT OF TREASURY WASHDC
RHEHNSC/NATIONAL SECURITY COUNCIL WASHDC

UNCLAS SECTION 01 OF 03 SAO PAULO 000241

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E.O. 12958: N/A
TAGS: [ECON](#) [EFIN](#) [BR](#)
SUBJECT: A NORMAL ECONOMY - BRAZIL AND THE FINANCIAL CRISIS

REF: 08 Sao Paulo 476

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Although Brazil has experienced a large shock as a result of the global economic downturn, it has weathered this shock much more effectively than past shocks due to greater economic flexibility, large foreign reserves, and a decline in inflation pass-through pressures that has made its economy much less vulnerable to the risk of exchange rate depreciation. Brazil's current account deficit has widened modestly in recent quarters but is not at risk. Brazil's imports are adjusting rapidly to the external shock and its floating exchange rate should help to stabilize any future trade imbalances that might emerge. Brazil's current account deficit also remains fully financeable via expected FDI inflows.

¶2. (SBU) Brazil's financial account has suffered a much larger and more sudden shock but is also not at significant risk. The recent increase in short-term financial outflows poses little risk because inflationary pass-through pressures are now much lower in Brazil than in the past. FDI inflows, moreover, are expected to remain strong. Brazil's large foreign reserves have provided it with a critical safety net throughout the crisis. More broadly, the improvement in Brazil's external accounts in recent years has helped to provide the Brazilian Central Bank (BCB) with genuine monetary independence, and helped make Brazil "a normal economy" for the first time in its history. Unlike past crises, interest rates can be used to help Brazil achieve its domestic growth and inflation objectives rather than managing its external imbalances. End Summary.

Coping with a Strong External Shock

¶3. (U) The global economic downturn has had a considerable impact on Brazil's balance of payments accounts. Three specific shocks Brazil has experienced include a large decline in trade flows, a sharp rise in financial outflows, and a large increase in outward profit transfers. Brazil's imports and exports in recent months have declined by 40 percent and created significant hardships for trade-intensive sectors. A large and sudden reversal in financial outflows occurred in the final quarter of 2008 after more than two years of strong inflows. Outward transfers last year jumped to USD

34 billion - 50 percent higher than their level in 2007 and more than double their level in 2006.

¶4. (U) While the decline in trade flows is due to weak demand affecting the entire global economy, remittance and financial outflows have been more specific to Brazil. Remittance outflows have been driven by struggling U.S. banks and car makers repatriating profits from their Brazilian units (very profitable until recently). Short-term financial outflows have been driven by foreign institutional investors liquidating local investments to boost their cash positions. While Brazil's open capital account and the depth of its markets are key long-run strengths of its financial system, they also make it easy for foreign investors to unwind their investments in the short-run and thus may have contributed to the recent rise in Brazil's financial outflows.

¶5. (U) Despite these recent difficulties, Brazil's external accounts are not at risk. While trade flows are down sharply, Brazil's trade balance maintains a slight surplus. The pace of remittances is expected to moderate significantly this year. Short-term financial outflows have hurt Brazilian equities (where foreign investment is most concentrated), but had a more modest impact on debt and credit markets given Brazil's limited reliance on foreign borrowing. FDI inflows have fallen from their recent peak levels, but generally remain strong. Most immediately, Brazil's USD 200 billion in foreign reserves provide it with a strong cushion against any reasonable external shock scenario. On balance, Brazil's external vulnerability indicators have shown a low level of risk throughout the crisis and remain far stronger than they were several years ago.

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Brazil's Current Account: A Mild and Gradual Shock

¶6. (SBU) Brazil's current account deficit has widened over the past year but remains modest in size (approximately -1.7 percent of GDP through March) and can be fully financed via FDI inflows (Reftel). External deficits in Brazil's two previous crises, by comparison, were much higher (-4.8 percent in 1998-99 and -4.6 percent in 2002-03) and required large-scale IFI financing. The most immediate source of the current account decline has been the increase in profit transfers. Brazil's trade balance has also fallen, but remains in surplus (USD 16 billion forecast in 2009) and is not at serious risk of deterioration given Brazil's flexible exchange rate and strong recent declines in import prices. The market consensus for Brazil's 2009 current account deficit is now -1.0 percent of GDP.

¶7. (U) In the short-run, Brazil's trade balance has weakened in part because its growth and import demand, while falling sharply, have held up better than its key trading partners (U.S., Argentina). Over the past quarter, exports to the U.S. have fallen by 50 percent. In contrast to past crises, however, Brazil's imports in this crisis are adjusting almost as rapidly as its exports helping to limit the risk that a large external deficit may open up. Brazil's import composition is also holding up well. Whereas fuel imports (largely reflecting cyclical conditions) have fallen by 40 percent, capital imports (largely reflecting longer-term expectations) have fallen by less than 10 percent.

Brazil's Financial Account: A Large and Sudden Shock

¶8. (U) Brazil's financial account, in contrast, has suffered a large and abrupt shock. After USD 54 billion in net financial inflows received during the first three quarters of 2008 (and USD 89 billion in 2007), Brazil suffered USD 21 billion in net outflows in the last quarter of 2008. Outflows were concentrated within Brazil's portfolio accounts - most immediately, among its equities. In contrast, FDI inflows remain strong. Even in the final quarter of 2008, Brazil received USD 14 billion in FDI inflows - more than twice FDI inflows received in the last quarter of 2007. The BCB expects FDI inflows to be USD 22 billion this year.

¶9. (U) Despite the recent reversal in its financial flows, Brazil's financial account is not at risk. One reason is the modest size of its external funding needs (approximately USD 60 billion in 2009) and large foreign reserve assets. A second reason is that financial outflows have been externally driven, have not reflected a rise in "Brazil risk," and thus may rebound quickly once global conditions ease. January-February data indicate that net financial inflows have again turned positive. The third and most important reason is the fact that Brazil can now tolerate a much greater degree of exchange rate depreciation without generating strong pass-through pressures. Since mid-2008, the Brazilian currency has depreciated by 22 percent in real effective terms. Whereas currency depreciation on this scale would have previously risked an inflationary spiral, inflation expectations today remain well-anchored and have fallen by nearly 100 points (to 4.2 percent) over the past two quarters.

¶10. (U) The decline in exchange rate pass-through has provided the BCB with much greater room to lower rates and stimulate domestic demand. In previous crises, rates were tightened sharply (amidst rapidly slowing growth) to help limit inflation, imports, capital outflows, and re-establish Brazil's external balance. In this crisis, in contrast, rates should fall by roughly 300 points. Brazil's benchmark rate is now lower than at any time in over two decades.

Foreign Reserves: A Critical Safety Net

¶11. (U) Large foreign reserves have been critical in assuring Brazil's stability throughout the crisis. At the outset of the crisis, Brazil had USD 205 billion in reserves. In 2007 alone,

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reserves grew by nearly USD 100 billion as financial inflows rose sharply. At that time, BCB president Meirelles was criticized for excessive reserve accumulation. By mid-2007, Brazil's reserves were well above normal reserve adequacy benchmarks (e.g., three to four months import coverage, 100 percent short-term debt, 10 to 20 percent of broad money). As of end-2008, Brazil's foreign reserves remained equivalent to 14 months of imports, 400 percent of total short-term external debt, and 40 percent of broad money.

¶12. (U) Brazil's large reserve stockpile has provided it with a strong safety net against severe external stress. When global markets panicked last September, the BCB sold large amounts of dollars without any risk of running down its reserves. The BCB could (and did) credibly claim it could meet any amount of local dollar demand. Brazil's foreign reserves now exceed its total external debt and its projected external financing needs through at least mid-2011.

Comment: Brazil as a "Normal Economy"

¶13. (SBU) Despite a large and sudden shock, Brazil's external accounts remain in excellent condition. While the current account deficit has recently grown, its size remains modest. Brazil's trade patterns are also adjusting well to the price and demand shocks faced in recent quarters. Short-term financial outflows have risen sharply, but pose little risk given Brazil's low funding needs and limited inflation risk that exchange rate depreciation now presents. Brazil's foreign reserves have provided an invaluable safety net throughout the crisis - ensuring Brazil's external repayment capacity and also helping to maintain confidence amidst difficult market conditions.

¶14. (SBU) The improvement in Brazil's balance of payments accounts has brought it two benefits: First, stronger external accounts have reduced Brazil's risk premium, contributed to its investment grade rating, and enhanced its ability to attract foreign capital. While Brazil's banks are not dependent on foreign finance, the increase in foreign capital inflows (in the pre-crisis period) did help to catalyze other parts of Brazil's markets that should recover when the crisis subsides, for example, Brazil's IPO market, merger and acquisition activity, and alternative assets. The second benefit is

increased space for counter-cyclical monetary policy. The BCB can now adjust rates in response to domestic rather than external conditions. For the first time in its recent history, Brazil has effectively achieved monetary independence, which some claim makes Brazil a "normal economy." End Comment.

¶15. (U) This cable was drafted in conjunction with the U.S. Treasury Financial Attache in Sao Paulo and coordinated/cleared by Embassy Brasilia.

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